

Franchise's place within sustainable development matrix: an institutional economics approach

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Abstract. *The aim of this article is to emphasize the major contribution of franchise, as hybrid institutional arrangement and governance structure, on the mechanism of sustainable development. Transaction costs illustrate a permanent obstacle which hinders healthy, long-term development. Using the theoretical tools of the New Institutional Economics we admit that, placed between the market and the firm, mixed governance structures are able to limit all these costs. Among them, franchise is the closest to the optimal model. Considering its profound social and economic valences franchise might be considered a vector of sustainable development.*

Keywords: franchise, transaction costs, governance structure, sustainable development.

JEL Classification: Q01, O43, O17.

REL Classification: 13C.

1. Introduction

Sustainable development is a subject of great interest with a deep impact on economic analyses. Beyond identifying the sources to generate progress and prosperity the attention of economic theory was focused more recently on the achievement of such goals in a particular context of awareness and improving some severe disruptions such as: environmental pollution (Shqau, 2012, p. 1535), limited availability of natural resources threatened by depletion, inclusively the holistic rate of demographic expansion. Policies oriented to sustain economic growth, the conservation of natural resources, thus improving the quality of life become nodal aspects that are to be met in the building process of sustainable development (United Nations, 1987, pp. 2-3).

According to François Perroux, sustainable development is “a combination of mental structures and social population changes that allows continuous cumulative growth of the global gross domestic product” (Perroux, 1982, p. 32). The author stresses that such changes of the mental structures and social habits precisely allow the expected growth, able to transform the particular progresses in a social general progress. His ideas are on the same wavelength with the vision proposed by P. Guillaumont that also nominates the changes of mental structures and social behavior as determinants of sustainable development (Guillaumont, 1985). The necessary adjustments for promoting sustainability are not deprived of costs, especially, transaction costs. In such circumstances, the entire economic or social activity needs to be projected on new coordinates of higher efficiency.

Trying to answer the question: which way of organizing economic activity serves best the principles and requirements of sustainable development?, we notice that the theoretical tools of the NIE, based on Oliver Williamson’s theory of governance structures illustrates a nodal landmark. From this perspective, we observe that, located at the interference of market and firm, mixed governance structures capture the benefits of both, the internalization of economic activity at the firm level and its placement in the market area, respectively.

Issues like the common establishment of resources, specific contractual relations and highly competitive environment are features able to enhance the viability of mixed structures (Ménard, 2003). Among them, franchise is considered as closest to the optimal hybrid in the light of internal equity, transparent conduct between parties, symmetrical distribution of information, implicitly the perpetual learning processes that it involves. Given the motivation and efficiency which supports its fair relational process franchise is entitled to a special place within sustainable development matrix.

2. Transaction costs – the hidden part of sustainable development

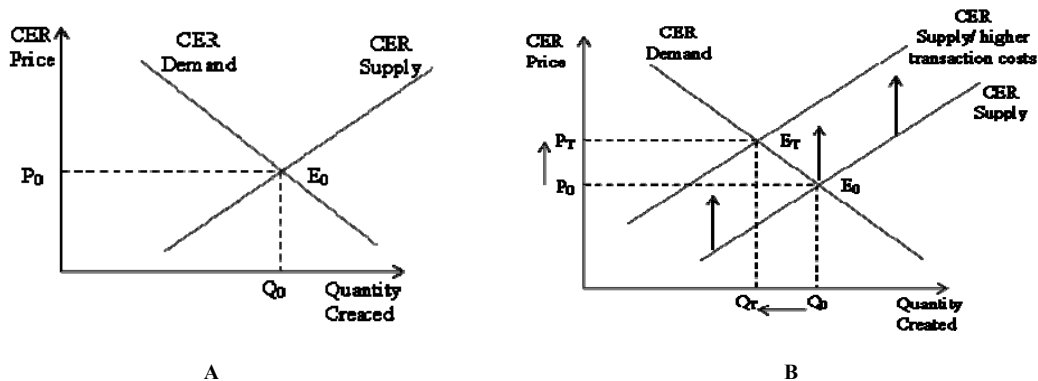
The concept of sustainable development captured the forefront attention after the normative goal proposed in the report of the World Commission on Environment and Development, from 1987, entitled *Our Common Future. From One Earth to One World*. The new directions of development were strictly connected with attention paid to the conservation of natural resources and the improvement of the quality of life (Tsekos, 2013).

The costs associated with research activities or identification and implementation of such measures illustrates, in terms of the New Institutional Development (NIE), transaction costs. Kenneth Arrow defined them as “the operation costs of an economic system” (Arrow, 1969). We consider two types of transaction costs. On the one hand, there are *ex-ante costs*, those of projecting, negotiating and protecting the agreement for sustainable development, as fees imposed for the emission of certain products (Tudor, 2012). On the other hand, there are *ex-post costs* that might take various forms, from assessment and supervision of transaction partners’ conduct, to the pursuit or retrieval of any damage arising from failure to comply with contractual rules (Williamson, 1985).

The provisions of the Kyoto Protocol underline an important example for both hypostases. As a legal instrument, it supports sustainable development in terms of attention paid to emissions control of greenhouse gases. The limitation of pollution under the principle of “common, but differentiated responsibilities” is not avoiding the problem of transaction costs despite the proposed mechanisms (United Nations, 1997).

Certified emission reduction (CER) credits attest the existence and manifestation of transaction costs. They might be seen as “part of emission reduction’s price that cannot be attributed to the physical process of removing greenhouse gases from the atmosphere” (McCloskey, Joseph, 2005) as highlighted in Figure 1 below. Furthermore Chadwick, in turn, stresses that their negative impact is affecting sustainable development mechanism by increasing the costs of certificates creation and expanding the costs associated to their trading process between nations (Chadwick, 2006).

Figure 1. Transaction costs implications on certified emission reduction's price



Source: McCloskey, A., Joseph, T.J. (2005). "Reducing Transaction costs of the clean development mechanism", *Workshop in Applied Earth Systems Policy Analysis*, Columbia University, p. 261.

A situation illustrates the hypothetical assumption of zero transaction costs. The equilibrium is reached in E_0 point, which corresponds to a quantity Q_0 of greenhouse gases removed from the atmosphere. If we take into consideration the real situation B, where the mechanism of sustainable development implies the existence of transaction costs, we might notice that such costs are able to induce an upward displacement of the supply curve to the right, while the demand curve remains unaffected. The new equilibrium point will be reached in E_T , corresponding to a higher level of prices regarding the creation of certified emission reductions and a smaller amount of greenhouse gases removed from the atmosphere. Extrapolating all these aspects at the level of sustainable development measures there is a critical need to identify a solution for minimizing transaction costs.

3. The nexus between franchise and the social dimension of sustainable development

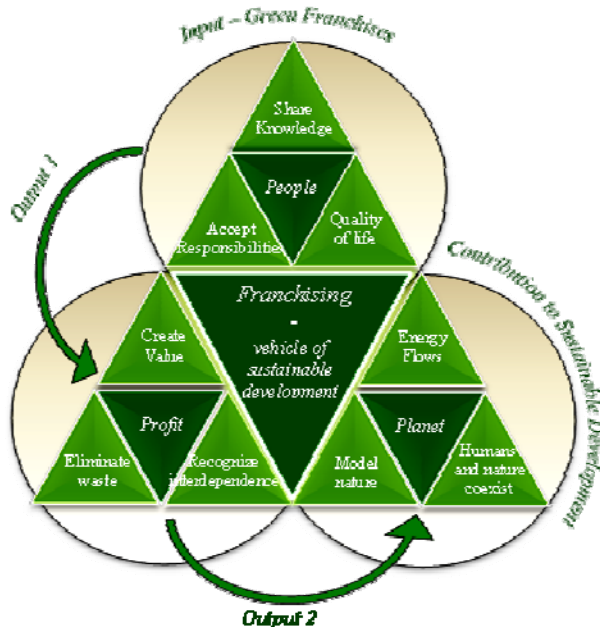
Requirements raised by sustainability are in accordance with the theoretical tools of the NIE vision. The settlement of the antinomy sustainable development – transaction costs has its correspondent within Williamson's governance structures. His theory nominates transaction as *basic unit of economic analysis* (Williamson, 1998) and economic governance as nodal condition for the optimal allocation of resources and the increase of economic efficiency, respectively. Tangentially to market and firm, Williamson particularizes a third form, *the hybrid structure* (Williamson, 1996) a self-contained structure which borrows features from both areas. From a general perspective, the main aspects of differentiation between the governance structures are referring to the intensity of incentives and the level of administrative control, on the one hand, and the types of specific adaptability and contractual elements, on the other hand (Williamson, 1991), as emphasized in Table 1.

Table 1. *The defining features of governance structures*

Attributes	Market	Hybrid (Franchising)	Hierarchy
Instruments	++	+	0
▪ Incentive intensity	0	+	++
▪ Administrativ controls			
Performance attributes			
▪ Adaption (A)- autonomy	++	+	0
▪ Adaption (C)- cooperation	0	+	++
Contract law	++	+	0
	<i>Clasic (legal)</i>	<i>Neoclastic (relational)</i>	<i>Subordination</i>
++ (strong); + (semi-strong); 0 (weak)			

Source: Own adaption after Williamson, O. (1991). „Comparative Economic Organization: The Analysis of Discrete Structural Alternatives”, *Administrative Science Quarterly*, Vol. 36, No. 2, p. 279.

Hybrid structures, namely the franchise, enjoy a moderate level of incentives and administrative control; it adapts to new circumstances combining autonomy and cooperation. Through the contractual relationship the franchise promotes cooperation and mutual support acting downwards transaction costs. From such perspective its contribution is therefore oriented to facilitate sustainable projects. In order to achieve a better placement of franchise within the area of sustainable development, we would like to highlight some attributes which recommends it as an antidote to the problem of transaction costs, as highlighted in Figure 2.

Figure 2. *The contribution of franchise to sustainable development*

Source: Personal adaption after Mock, T., Wernke, T. (2011). „Sustainable Land Development Initiative – The Universal Principles of Sustainable Development” Triple Pundit, available at <http://www.triplepundit.com/2011/02/universal-principles-sustainable-development>.

The first aspect which connects franchise with the social sphere of sustainable development concerns its *contractual structure* itself, projected to be viable. We consider the *neoclassical* pattern of *contract*, with numerous clauses designed to reduce uncertainty, opportunistic behavior, thus transaction costs. Franchise specific flexibility derives from the *incompleteness of contractual framework*, which furnishes the general cooperation action area, but also the necessary openness for the ex-post adjustments (Llewellyn, 2009). Thus, subsequent amendments are allowed without paying additional costs.

Another advantage lies on the pattern of relational contract which serves as *self-regulation element* (Ménard, 2004). In other words, beyond the identity of the involved parties, the franchise is based on a deep commitment designed to ensure the *continuity of contractual relations*. The cooperation of the parties becomes the guarantee of transparency and internal equilibrium indispensable for viable projects. Franchise involves the exploitation, not the transfer of intellectual or industrial property rights. Based on the *residual rights of control* the franchisor is protected and may correct any opportunistic intentions of its franchisees. Placed between the market and the firm franchise brings a notable contribution to the social and economic dimensions of sustainable development, due to its internal balance, harmony and relational sustainability. The entrepreneurial model of franchise allows the assimilation and expression of all components required by sustainable development. For the beginning, we consider the contribution brought to the social sphere.

As shown in the Figure 2, the peak of the pyramid, *share of knowledge*, goes directly to the substance of the relationship between the franchisor and the franchisee. Know-how circulation and the experience acquired by the franchisor ensure the social sustainability of franchise as a governance structure. Beyond its internal equilibrium, the longevity at the market level depends on franchisor's ability to fold the new requirements. Taking into consideration that the prestige of any franchise requires network homogeneity and ethical conduct, this hybrid form of governance implies *acceptance of responsibilities*. There is a mix between franchisee autonomy and the acceptance of coordination for maximizing the economic, environmental and social benefits. Obviously, a careless franchise system in terms of social or environmental responsibilities will lose *reputation*. Therefore, the success of any franchise network is based on two major coordinates: attention paid to the quality of goods and services and higher responsibilities with regard to generated effects on social and natural environment. This is the proper way to acquire the necessary credibility for a sustainable business, worthy of being followed by the rest of economic agents.

Franchisee success feeds the economic benefits of the franchisor by paying regular royalties. From this perspective eliminating waste in the act of resource consumption and production emphasize a permanent concern of the parties.

Beyond that, franchise as a governance structure remains dedicated to sustainability through the interdependence which occurs between contractual parties. On the one hand, the franchisee is subordinating to the claims of the business owner, as disposes of an entrepreneurial pattern previously tested which guarantees the success. On the other hand, the economic benefits of the franchisor and its fame are dependent in a certain extent on the franchisees activity. Due to the attention paid to economic profitability, achieved through sustainable measures, the franchise will inherently contribute to the sustainable development of the society to which it belongs.

Transition to the efficient means of production and consumption, renewable energy sources and innovations illustrates an indispensable component of entrepreneurial activities animated not only by the profit maximization, but also by their sustainability. From this point of view we admit the placement of franchise on the new coordinates of ecological dimension. According to Harvard Business Review, the commitment to sustainable practices is not a barrier to profitability, but rather a source of reducing costs and increasing revenues. The internalization of ecological advantages is providing a higher competitiveness (Globe Foundation, 2010). In such context franchise underlines its characteristic flexibility and provides, once more, the evidence of viability. Statistics show that the number of franchisors who have made deliberate efforts in order to reduce the negative impact on the environment is constantly expanding. Economic practices that have made the successful transition to “green economy” exceeded 5.2 trillion US\$ in 2010 (Franchise Direct, 2010). In the context of global warming and the measures taken to reduce this risk through the amendments to Kyoto Protocol in December 2012, from the Doha conference on climate changes, the attention paid to ecological sphere has significantly increased. In response to these aspects, there are two major forms of manifestation of the eco-franchises globally: *franchises which directly contribute to environmental protection* and those *which involve the use of advanced technologies and environmental practices* (Franchise Direct, 2010).

The adoption of new technologies and gaining competitive advantages in terms of environmental practices awarded franchise with a major contribution to stimulating a responsible behaviour in the human-nature relationship. Its increased mobility allows the propagation of mechanisms able to ensure geographical sustainable development through franchisees. By its inner nature franchise might

be considered a real vehicle of sustainable development, phenomenon which requires an extensive process of institutional change, mainly, of formal institutional area. Although the results in terms of institutional response to sustainability issues tend to remain poor, franchise, as an optimal hybrid has the capacity to induce cooperation at the level of intent and effects (Connor, Dovers, 2004). So it might be perceived as a tool for reducing transaction costs, but also as a transmission channel of sustainability principles (Gunderson, et al., 1995).

4. Conclusions

The attention paid to the preservation of natural resources in order to keep them alive for future generations brought the principles of sustainable development on the same wavelength with the path dependency idea proposed by the institutional economist Douglass North. From such perspective sustainability implies a strong moral weight, according to which, the capabilities of each society to build its future is strictly dependent on the genetic heritage, natural resources in this case. Like any global project, sustainable development cannot be achieved without the ubiquitous transaction costs. In this context, there is a profound need for identifying a solution to this problem.

Oliver Williamson nominates the hybrid governance structures. We nominate a particular structure: franchise. On the one hand, aspects such as knowledge transfer, reputation and the acceptance of responsibilities, or the inner relational equilibrium provided by contractual valences strengthen franchise's contribution to the improvement of social sphere, required by sustainable development. Furthermore, as a hybrid governance structure, franchise allows the reduction of transaction costs and waste in resources consumption, encouraging economic efficiency. On the other hand, the attention paid to the environmental preservation through transition to alternative energy sources, technological innovations able to facilitate energy efficiency and permanent care for the ecological dimension, highlight franchise's ability to support the fundamental area from the "trophic chain" of sustainable development. All these particular aspects convert franchise into a vector of sustainable development due to the attention paid not only to economic, but also social and environmental spheres.

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